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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
125 East 93rd Street
New York City 28

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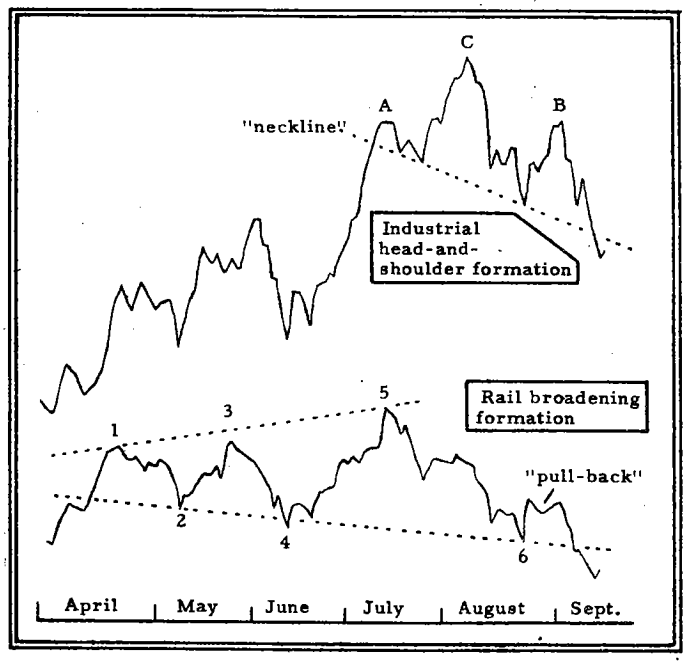
A NEW THEORY? During the twenty years since the death of Robert Rhea, few students of the Dow Theory have come forth but many have capitalized on the name. Some have found it profitable to tack the words "Dow Theory" on their own brand of journalism; others have announced that they have "improved" the Theory and thus transformed it into a new and wondrous device. Several widely advertised "Dow Theory" services claim that through the use of the Theory they can forecast the length and height of a bull market, the extent and depth of a secondary or even pick individual stocks to "double" and "triple". More incredible still, they can now predict in advance the path which the averages will travel. No longer must "old fashioned" adherents of the classical Theory wait for the averages to point the way -- the way is accurately forcast by the new Dow Theory services far in advance. Unfortunately, as in the case of the recent market reversal, the fates are not always kind to the oracles. And those twin sins which Rhea labeled "quackishness" and "pride of opinion" once more suffer at the hands of an uncooperative market. In the vast majority of cases, those who pervert the principles which were developed by Dow, Hamilton and Rhea do untold harm to the Dow Theory, their own reputations, and their subscribers' pocketbooks.

This series of Letters was initiated primarily to teach the value of Dow's Theory as an aid to businessmen and investors. If I were a talented enough exponent of the Theory I would probably find myself out of a job within a few years. The reason is obvious -- in due time readers of these Letters would have absorbed all that I could teach them, and they would be able to draw their own conclusions regarding the price movements. But since many market veterans (and we have a large number of such subscribers) like to check their own opinions against mine, and since many new readers express a desire to learn something of Dow's Theory, the list of subscribers to these Letters (somewhat to my surprise) continues to grow larger.

FORMATIONS. On rare occasions certain classical patterns appear in one or the other average. The 1957 industrial top was a "broadening top", and this was discussed at length in Letter 69. I also stated that the 1957 industrial structure was the only completed broadening top ever to appear in an average. Last week for the first time in history a broadening formation was completed in the rail average (see chart). This was all the more amazing because at the same time a "head-and-shoulder" formation was completed in the industrial average.



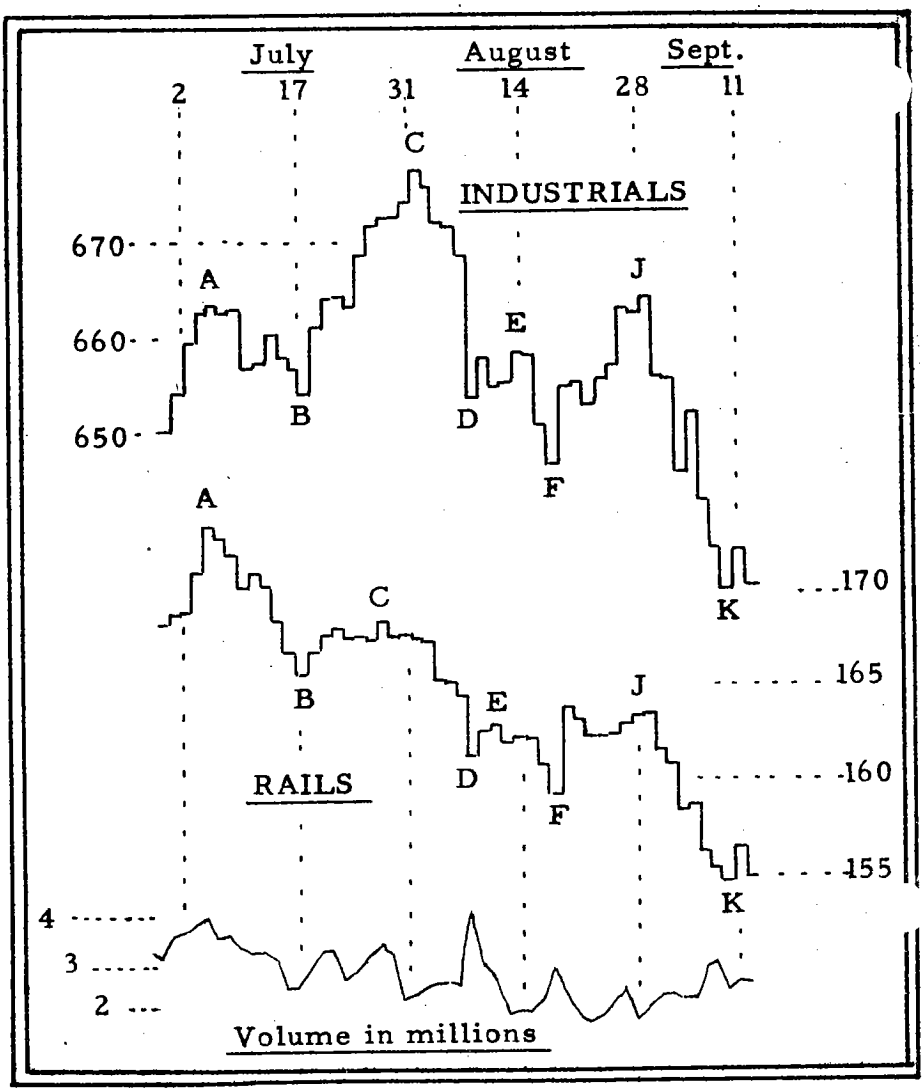
A broadening top is a series of successive highs and lows, each high above the preceding high and each low below the preceding low. The classical broadening top is a five point reversal pattern. Following the fifth reversal (pt. 5 on chart), the lower trendline will be approached (pt. 6); then more often than not an aborted "pull back" will retrace part of the distance towards point 5 as

volume falls off. Subsequent to the pull-back, the pattern is completed by a violation of the lower trend line. This is exactly what has recently occurred in the rail average.

Broadening formations usually imply lack of control, technical weakness and distribution. Because so many individual stocks presented broadening formations during the 1929 top, the appearance of this structure invariably causes anxiety among chartists.

A glance at the industrial section of the chart will show another pattern well known to individual stock chartists -- the "head-and-shoulders" formation. This is one of the commonest and most reliable reversal formations. Here the left shoulder (A on chart) and the right shoulder (B) are separated by a taller head (C) while volume diminishes progressively from the left shoulder through the head and is lowest at the right shoulder. The "neckline" or crucial support is shown by the dotted line on the chart. In this particular case the neckline slants downward -- a more bearish manifestation than either a horizontal or an up-slanting neckline. A violation of the neckline following the right shoulder completes the head-and-shoulders reversal. It is of historical significance that both the 1929 and 1946 tops were of the head-and-shoulders variety. I wish to emphasize that the study of formations is not part of the Dow Theory. Nevertheless, I felt that readers would find this discussion of interest, particularly since, to my knowledge, this is the first time in history that these formations have appeared in both averages simultaneously. As far as I am concerned, the appearance of these two patterns does not necessarily imply that the bull market has topped out. It does imply, however, that extreme caution is warranted.

PRICE MOVEMENTS. In Letter 77 I said that I would consider the secondary trend as having turned down if the F points were violated on increasing volume. Following the minor J peak (see chart), both averages turned abruptly down, and on September 3 the F points were violated on rather indecisive volume. A one-day rally followed, but on this move (1) volume decreased, (2) rails edged up a mere 0.14 against over 6 points on industrials. Following the Labor Day holiday, further doubt as to the secondary trend of the market was erased as both averages retreated again, and this time industrials decisively violated the F points as volume expanded to almost 3 million shares.



By September 10 persistant selling had taken industrials to 633.38 and rails to 154.52. This meant that in the space of 7 trading days industrials had lost 31.03 points and rails 9.03 points, a rather severe sell-off by any standards. On September 10 selling pressure eased to 2.5 million shares, and this suggested that the market was preparing for some sort of correction of the previous drop. The rally came at the end of the week with volume picking up slightly. One day indications are seldom decisive and Monday's sell-off on slightly lower volume was, in my opinion, such a day.

We have not had an up-day with better than 2.7 million shares since July, while most of the impressive action has been on the downside. Although a technical rally retracing some part of the distance to J may be in order, present indications are that the secondary trend continues down. Because of this, those who buy the first rally are gambling recklessly -- there has been nothing in the price movement (so far) to imply that the selling is over. If last week's K points (industrials 633.38, rails 154.25) are now violated the prediction will be for lower prices. A rally towards J followed by a second approach to the K points on sharply decreased volume would be the first hint that the selling was at an end.

SECONDARIES. Despite the almost unanimous bull chorus which has recently emanated from market columnists, analysts, professional bulls and corporate leaders, it should come as no surprise to readers of these Letters to learn that the secondary trend of the market is now down. "How could the market decline in the face of all the wonderful business news?" asks the neophyte. Perhaps Hamilton best answered this question when he wrote, "News known is news discounted. What everybody knows has ceased to be a market factor..." In general, secondary reactions come when least expected and when the consensus has it that lower prices are "impossible". Secondaries serve a number of purposes: (1) they may correct the previously uncorrected primary swing and its accompanying excesses; (2) they may discount a forthcoming recession in business or a period of unfavorable news; (3) they serve to dampen the enthusiasm of amateur speculators; (4) they remind chronic bulls that the market travels in two directions.

A study of the history of the averages will show that retracements such as the present one arrive at irregular intervals, and they follow a set pattern with remarkable uniformity. Subsequent to an extended primary swing, one average gets "out of gear" with its companion or perhaps one indicator advances to a new high and this high is unconfirmed by the other. The two averages then turn down (often in deceptively leisurely fashion), and this may signal the beginning of a sharp decline or a secondary reaction. On a few occasions it has marked the start of a bear market.

At a certain point the decline may pick up velocity as stop-loss orders are touched off and investors' fears are aroused. In the case of a full-scale secondary, it is usual for high volume to accompany the last day or so of selling. Yet every movement of the market tends to overrun itself (if only temporarily), and so it is with reactions. The market becomes oversold, shorts hasten to cover, and the boys on the floor of the Exchange, sensing the turn, hop in for the inevitable rally. It is what happens after this automatic rebound that provides the key to the future. There are two alternatives:

(A) following a normal correction of the reaction -- say an advance which retraces 1/3 or more of the ground lost during the reaction -- another downward move will commence. If the factors which caused the reaction are of a worsening nature, the reaction lows are sure to be violated. If this occurs in the third phase of a bull market, a primary bear signal will have been given.

(B) if the cause of the reaction has been fully discounted in the price structure, then on the second decline one or both averages will hold above the previous reaction lows and volume will contract sharply as these lows are again approached. This low-volume "test" constitutes a "buy-spot" under the Dow Theory. Following the buy-spot, an advance of both averages over their previous highs will signify that the primary trend of the market continues bullish and that those who made purchases at the buy-spot were correct.

THE WRITER WONDERS Journalists and economists, in examining the implications of the rapidly rising interest rates, have taken up the cry of "more inflation". If the market were impressed with the new "inflation" talk, then it seems to me it would begin to discount that possibility by rising or inflating itself. Instead, it has chosen to protect itself against

coming events by deflating. Could the market be wrong -- or is it the economists who are mistaken?

Rhea once wrote that collapses usually occur when the experts are putting the next bear market six months to a year away. It bothers me that most of the sophisticated analysts and technicians -- men who sincerely believe in bull and bear markets -- are shrugging off the current decline and promising new highs for the averages by the end of the year. I know any number of smart investors who are ready to admit that a bear market could appear in 1960 or 1961, but these same men are shocked at the thought of one's occurring now. It seems to me that if a bear market did take place here, the public as well as the entire Wall Street fraternity would be caught napping, whereas if one occurred in a year or so amid the much-wished 750 to 900 area on the Dow Jones industrials, even the amateurs would find it easy to exit with profits. This does not imply that we are now in a bear market. Yet Dow Theorists are entitled to suspect that any recession in the third phase of a bull market could be the first leg of a bear market. The primary trend cannot be reaffirmed as up until such time as both averages better their previous highs (industrials 678.10, rails 173.58), and this is the reason that I have talked "insurance" in so many recent Letters. Protection of hard-earned capital, to my mind, is more important than possible speculative profits.

From all reports the market will roar up as soon as the steel strike is settled. This may be true but during the 1952 and the 1956 strike the market discounted the good news and sold off at the settlement.

STOCKS. As readers may have guessed, I am not going to recommend purchases at this juncture. I do suggest putting idle funds in the 91 day Treasury bills which are yielding a whopping 3.96% interest. If the present trend in interest rates continues, these can be turned in at the end of maturity for the next series which will probably be going at an even higher yield.

More than half of the stocks on the board are in weak or bearish patterns. When a stock has violated a support area, it is normal during rallies for that stock to advance towards but not over the previous support level. For this reason chartists say that when a support level is broken, that support line immediately reverses itself and becomes a resistance level. In most cases, it takes a good deal of "work" or accumulation before a stock that has violated its support can turn around and rally over it again.

(Written September 14, 1959 - after the close)

Thirty Stocks Used in Dow Jones Industrial Averages are:

Allied Chemical	General Electric	Sears Roebuck
Aluminum Co.	General Foods	Std Oil of Cal.
Amer Can	General Motors	St. Oil of N. J.
Amer Tel & Tel	Goodyear	Swift & Co.
Am Tobacco	Inter Harvester	Texaco Inc.
Anaconda Co.	Inter Nickel	Union Carbide
Bethlehem Steel	Inter Paper	United Aircraft
Chrysler	Johns Manville	U. S. Steel
Du Pont	Owens-Ill. Glass	Westinghouse El
Eastman Kodak	Procter & Gamble	Woolworth

Twenty Railroad Stocks Used are:

Atchison	Erie	NY NH & H
Atl Coast Line	Great North Ry	Norfolk & West'n
Baltimore & Ohio	Illinois Central	Pennsylvania
Canadian Pacific	Kansas City So	Southern Pacific
Ches & Ohio	Louisv & Nash	Southern Railway
Chi Rk Is & Pac	N. Y. Central	Union Pacific
Del & Hudson	N Y C & St. L.	